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PAGE 01 ROME 10655 01 OF 03 281724Z
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S E C R E T SECTION 1 OF 3 ROME 10655

E.O. 11652: GDS
TAGS: ECON, PINT, IT
SUBJECT: ANDREOTTI VISIT PART I: POLITICAL/ECONOMIC SETTING

1. INTRODUCTION. THIS TELEGRAM IS THE FIRST OF FIVE
(POLITICAL/ECONOMIC SETTING; ANDREOTTI PROFILE; OBJECTIVES/
RECOMMENDATIONS; PUBLIC AFFAIRS; AND FORLANI PROFILE)
ON THE JULY 26-27 VISIT OF ITALIAN PM ANDREOTTI TO WASHINGTON.)
CURRENT ATTENTION ON ITALY FOCUSES ON TWO INTERRELATED
POLITICAL AND ECONOMIC ISSUES. THE FIRST IS THE GROWTH
OF COMMUNISM AND THE WEAKNESS OF ITALY'S DEMOCRATIC
PARTIES. THE SEOND IS ITALY'S PROFOUND ECONOMIC ADJUST-
MENT PROBLEM CAUSED PARTLY BY PAST MISMANAGEMENT BUT
PARTLY BY ITS VULNERABILITY TO OUTSIDE SHOCKS. IN THE
FACE OF THESE DIFFICULTIES ANDREOTTI'S CHRISTIAN DEM-
OCRATIC (DC) MINORITY GOVERNMENT, SUPPORTED BY THE
ABSTENTIONS OF THE COMMUNISTS (PCI) AND THE SMALL INTER-
MEDIARY PARTIES, HAS PROVED MORE DURABLE AND HAS
ACCOMPLISHED MORE THAN MOST PEOPLE WOULD HAVE DARED PREDICT.
NEVERTHELESS, VERY SERIOUS PROBLEMS REMAIN. ECONOMICALLY,
WHILE SOME INITAL CORRECTIVE MEASURES HAVE BEEN TAKEN,
THESE ARE NOT SUFFICIENT BY THEMSELVES TO ASSURE STABLE
GROWTH AND JOB CREATION OVER THE LONG RUN. POLITICALLY,
ITALY IS LIKELY TO REMIAN UNSTABLE FOR SOME TIME, WHICH
BOTH COMPLICATES EFFECTIVE ACTION ON THE ECONOMIC FRONT
AND HOLDS SERIOUS IMPLICATIONS FOR THE FUTURE OF ITALIAN
DEMOCRACY AND FOR ITALY'S ROLE IN THE ALLIANCE AND THE
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PAGE 02 ROME 10655 01 OF 03 281724Z

EUROPEAN COMMUNITY.

2. THE DIFFICULT POLITICAL FRAMEWORK
WITHIN WHICH THE ANDREOTTI GOVERNMENT HAS HAD TO OPERATE
SINCE THE JUNE 1976 ELECTIONS AND THE STATUS OF THE
ANDREOTTI GOVERNMENT'S ECONOMIC STABILIZATION AND RECOVERY
EFFORTS ARE DESCRIBED BELOW.

3. POLITICAL. PM ANDREOTTI'S VISIT TO WASHINGTON WILL MARK THE ANNIVERSARY OF HIS THIRTIETH YEAR IN GOVERNMENT POSITIONS AND THE FIRST ANNIVERSARY OF HIS PRESENT MINORITY, ONE-PARTY GOVERNMENT. HE IS, AS JAMES RESTON HAS CHARACTERIZED HIM, "DURABLE" PRIMARILY BECAUSE HE IS AN EFFECTIVE ADMINISTRATOR AND A SHREWD PARTY BUREAUCRAT WITH JUST THE RIGHT COMBINATION OF TALENTS TO SUCCEED IN THE ITALIAN POLITICAL MILIEU. (SEE BIO SEPTEL)

4. ANDREOTTI'S PRESENT MINORITY GOVERNMENT (CHRISTIAN DEMOCRATS ONLY) HAS LASTED FAR LONGER AND ACCOMPLISHED MORE THAN MOST PEOPLE WOULD HAVE DARED TO PREDICT WHEN IT WAS PUT TOGETHER A LITTLE LESS THAN A YEAR AGO, FOLLOWING THE PARLIAMENTARY ELECTIONS ON JUNE 20, 1976. THOSE ELECTIONS PRODUCED A POLITICAL STALEMATE IN THAT NO CLEAR PARLIAMENTARY MAJORITY COULD BE FORMED. THE CHRISTIAN DEMOCRATS' TRADITIONAL ALLIES, THE SMALL LAY PARTIES (REPUBLICANS, LIBERALS, SOCIALISTS, AND SOCIAL DEMOCRATS WITH A TOTAL OF ABOUT 17.5 PERCENT OF THE VOTE, WERE ALIENATED FROM THE DC BUT AT THE SAME TIME UNWILLING TO FORM A GOVERNMENT WITH ONLY OTHER LARGE PARTY, THE COMMUNISTS. THE RESOLUTION OF THE STATEMATE WAS INGENIOUS, A MINORITY DC GOVERNMENT "SUPPORTED" BY THE ABSTENTIONS OF THE PIC AND THE LAY PARTIES. ITS ABILITY TO ACT HAS DEPENDED ON A CONSENSUS
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PAGE 03 ROME 10655 01 OF 03 281724Z

ON EVERY ISSUE BETWEEN THE DC AND THE ABSTAINING PARTIES. THIS HAS INEVITABLY CREATED A TENDENCY TO MOVE TOWARD THE LOWEST COMMON DENOMINATOR. NONETHELESS, THROUGH SHREWD INTER-PARTY HORSE TRADING AND THEIR ABILITY TO MOBILIZE PUBLIC OPINION IN SUPPORT OF MEASURES NECESSARY TO DEAL WITH ITALY'S CURRENT CRISES, ANDREOTTI AND HIS GOVERNMENT SUCCEEDED IN NEGOTIATING THE FIRST STAGE OF ITALY'S ECONOMIC STABILIZATION AND RECOVERY EFFORTS, INCLUDING A STANDBY AGREEMENT WITH THE IMF.

5. ONCE THE GOVERNMENT'S "LETTER OF INTENT" CONCERNING ECONOMIC POLICY COMMITMENTS WAS SENT TO THE IMF (APRIL 16, 1977), THE PCI AND THE PSI LAUNCHED A SERIES OF INITIATIVES DESIGNED TO ACHIEVE A CHANGE IN THE POLITICAL AGREEMENT ON WHICH THE ANDREOTTI MINORITY GOVERNMENT IS BASED. THESE INITIATIVES WERE EXPRESSED IN TERMS OF THE NEED FOR A NEW AGREEMENT ON THE GOVERNMENT'S PROGRAM FOR DEALING WITH ECONOMIC, PUBLIC ORDER, AND OTHER ISSUES, BUT THE STRONGEST MOTIVATION WAS POLITICAL. THE POLITICAL OBJECTIVES WERE SEVERAL. THE PCI HOPED TO ACHIEVE A GREATER ROLE IN THE GOVERNING PROCESS (ANOTHER SLICE OF THE SALAMI OF RESPECTABILITY) BOTH

FOR ITS WON SAKE AND AS A WAY OF DAMPING DOW UNREST
AT THE PARTY'S MORE REVOLUTIONARY BASE BASE. THE LAY PARTIES
ALSO SOUGHT A LARGER ROLE BECAUSE THEY PERCEIVED THEM-
SELVES (CORRECTLY) AS BEING SQUEEZED BETWEEN THE TWO
LARGE PARTIES (DC AND PCI).

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PAGE 01 ROME 10655 02 OF 03 281734Z
ACTION EUR-12

INFO OCT-01 ISO-00 EURE-00 SS-15 EB-07 INR-07 /042 W

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TO SECSTATE WASHDC PRIORITY 5556

S E C R E T SECTION 2 OF 3 ROME 10655

6. THE NEGOTIATIONS TO END THIS IMPASSE HAVE TAKEN
PLACE AMONG PARTY OFFICIALS, I.E., SEPARATE FROM THE
GOVERNMENT AND FROM PARLIAMENT, WITH THE RESULT THAT, FOR
THE DC, MORO AND NOT ANDREOTTI HAS BEEN IN CHARGE.
HOPEFULLY, BY THE TIME ANDREOTTI VISITS WASHINGTON,
THESE NEGOTIATIONS WILL HAVE REACHED A CONCLUSION AND
GIVEN THE ANDREOTTI GOVERNMENT ANOTHER LEASE OF LIFE.
"HOPEFULLY" BECAUSE FOR THE TIME BEING THERE IS NO OTHER
WORKABLE ALTERNATIVE, AND THE ANDREOTTI GOVERNMENT
"FORMULA" APPEARS TO BE PROVIDING THE DC THE TIME IT
NEEDS TO REORGANIZE ITSELF AND TO TAKE ADVANTAGE OF WHAT
APPEARS TO BE INCREASING SUPPORT FOR THE PARTY AMONG
THE ELECTORATE. AT THE SAME TIME, THE PCI "SUUPPORT" FOR
THE MINORITY GOVERNMENT APPEARS TO BE CREATING STRAINS
WITHIN THE PCI AS THAT PARTY BECOMES INCREASINGLY
IDENTIFIED IN THE EYES OF ITS BASE WITH THE ESTABLISH-
MENT. IN ANY EVENT, THE ITALIAN POLITCAL SCENE APPEARS
LIKELY TO REMAIN UNSTABLE FOR THE FORESEEABLE FUTURE,
WITH NO PROSPECT FOR THE DEVELOPMENT OF A SOLID PAR-
LIAMENTARY MAJORITY (BASED ON EITHER THE DC OR THE PCI).

7. IN THIS EXTENDED PERIOD OF INSTABILITY, ANDREOTTI WILL
UNDOUBTEDLY CONTINUE TO PLAY A MAJOR ROLE. HE AND MORO
ARE NOW WITHOUT QESTION THE TWO SENIOR LEADERS OF THE
DC AND, IF MORO SUCCEEDS LEONE AS PRESIDENT OF THE REPUBLIC

IN DECEMBER 1978 (AS IT IS RUMORED HE VERY MUCH WANTS

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PAGE 02 ROME 10655 02 OF 03 281734Z

TO DO), ANDREOTTI WILL REMAIN THE MOST EXPERIENCED AND CAPABLE LEADER OF THE LARGEST DEMOCRATIC PARTY IN ITALY. HE WILL, NEVERTHELESS, HAVE GEAT DIFFICULTY IN TAKING CHARGE OF THE PARTY. UNLIKE MORO, FOR EXAMPLE, ANDEROTTI HAS NEVER HELD IMPORTANT PARTY POSITIONS, AND THERE IS STRONG OPPOSTION TO HIM BY A SUBSTANTIAL NUMBER IN THE DC. BASIC TO THIS OPPOSTION IS A CONCERN THAT HIS ALLEGED EXCESSIVE INTEREST IN REMAINING IN POWER COULD LEAD HIM INTO COMPROMISES WITH POLITICAL OPPONENTS THAT MANY IN HIS PARTY WOULD FIND UNACCEPTABLE.

8. ECONOMIC. THE ANDREOTTI VISIT TAKES PLACE DURING AN IMPORTANT TRANSITIONAL PHASE IN THE GOI'S EFFORT TO PUT THE ITALIAN ECONOMY BACK ON A STABLE ECONOMIC GROWTH PATH. BY END-APRIL, WITH FINAL IMF APPROVAL OF THE SDR 450 MILLION STANDBY AGREEMENT, THE GOI HAD COMPLETED THE FIRST PHASE OF THIS OPERATION WHICH IS AIMED AT REDUCING INFLATION AND IMPROVING THE BALANCE OF PAYMENTS, ALBEIT AT THE EXPENSE OF FASTER GROWTH. MAJOR STEPS TAKEN WERE INCREASES IN TAX REVENUES ANDPUBLIC TARIFF RATES SO AS TO REDUCE THE INFLATIONARY EFFECT OF VERY LARGE DEFICITS THROUGHOUT THE PUBLIC SECTOR AND MORE MODEST MEASURE IN THE AREA OF WAGE COSTS AND LABOR PRODUCTIVITY. IT IS TOO EARLY TO SAY WHETHER ALL THE TARGET WILL BE MET. HOWEVER, EVIDENCE TO DATE ON THE PRICE AND BALANCE OF PAYMENTS FRONT ARE ENCOURAGING.

9. DESPITE MUCH TALK OF ECONOMIC "CRISIS," THE REAL LEVEL OF ECONOMIC ACTIVITY IN 1976 WAS AT A RECORD LEVEL DUE TO RAPID RECOVERY FROM THE 1975 RECESSION. AS IN MANY OTHER COUNTRIES, AN IMPROVEMENT IN THE EMPLOYMENT SITUATION DID NOT KEEP PACE WITH RECOVERY OF THE ECONMY AND CONTINUES TO BE A SERIOUS PROBLEM. OUR ESTIMATES FOR

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PAGE 03 ROME 10655 02 OF 03 281734Z

CALENDAR YEAR 1977 ARE FOR VERY MODEST REAL GROWTH (2-2.5 PERCENT), A SIGNIFICANT IMPROVEMENT IN THE INFLATIONARY SITUATION (13 PERCENT RISE IN THE COST OF LIVING FROM DECEMBER TO DECEMBER), A REDUCTION IN THE DEFICIT ON CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS FROM ALMOST \$3 BILLION TO LES THAN \$1 BILLION, BUT ONLY A MODEST IMPROVEMENT IN THE EMPLOYMENT SITUATION. WHILE THE GROWTH AND EMPLOYMENT SCENARIO ARE RELATIVELY POOR,

ITALY'S BALANCE OF PAYMENTS RESTRAINT DOES NOT PERMIT MUCH FASTER GROWTH. THIS IS FAIRLY WIDELY RECOGNIZED IN ITALY AND ABROAD AS AN UNPLEASANT FACT OF LIFE. FURTHERMORE, OVER THE NEXT FEW YEARS, AS CENTRAL BANK GOVERNOR BAFFI SAID IN HIS END-MAY ANNUAL MEETING ADDRESS, ITALY CANNOT COUNT ON A GROWTH RATE OF MUCH MORE THAN 3 PERCENT.

10. THE SECOND STAGE OF THE ITALIAN ECONOMIC RECOVERY PLAN INVOLVES POLICIES AIMED AT RAPID EXPORT GROWTH, RECOVERY OF INVESTMENT, AND INCREASED EMPLOYMENT OPPORTUNITIES, ESPECIALLY FOR YOUTH. AS DISCUSSED AT THE RECENT LONDON SUMMIT MEETING, THESE OBJECTIVES ARE COMMON TO MOST INDUSTRIAL COUNTRIES WHICH ARE NOW FACED WITH IMPORTANT ECONOMIC ADJUSTMENTS TO THE REALITIES OF THE POST-ENERGY CRISIS SITUATION. BECAUSE ITALY IS EXTREMELY DEPENDENT UPON IMPORTED ENERGY AND MUST ALSO IMPORT MOST OF ITS OTHER PRIMARY MATERIALS IN ORDER TO EXPORT FINISHED GOODS, EXPORT GROWTH IS CRUCIAL BOTH TO AN ADEQUATE DOMESTIC GROWTH RATE AND TO ITALY'S POSITIVE CONTRIBUTION TO WORLDWIDE BALANCE OF PAYMENTS ADJUSTMENT. THIS MEANS THAT GROWTH OF ITALY'S EXPORT MARKETS AND PRICE COMPETITIVENESS ARE THE TWO KEYS TO THIS ADJUSTMENT. GROWTH OF WORLD MARKETS WILL BE IMPORTANT, BUT ITALY MUST ALSO FOLLOW AN EXCHANGE RATE POLICY WHICH KEEPS

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PAGE 01 ROME 10655 03 OF 03 281742Z
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S E C R E T SECTION 3 OF 3 ROME 10655

ITALIAN EXPORTS PRICE-COMPETITIVE. MOST IMPORTANTLY, DOMESTIC INFLATION OF PRICES AND COSTS MUST BE BROUGHT UNDER BETTER CONTROL BY REDUCING THE PUBLIC SECTOR DEFICIT AND BY ARRESTING THE RATE OF INCREASE IN ITALIAN UNIT LABOR COSTS WHICH, IN RECENT YEARS, HAVE GROWN FAR IN EXCESS OF THAT IN MOST COMPETING COUNTRIES.

11. EXCEPT FOR THE 1976 BOOM YEAR, INVESTMENT IN ITALY HAS BEEN AT VERY LOW LEVEL, WITH A CORRESPONDING REDUCTION IN THE RATE OF CREATION OF NEW JOBS. POOR INVESTMENT REFLECTS A VARIETY OF FACTORS INCLUDING POLITICAL UNCERTAINTIES, THE HIGH NOMINAL COST OF LONG-TERM BORROWING (REFLECTING THE HIGH RATE OF INFLATION), AN INADEQUATE GENERATION OF RISK CAPITAL, HIGH LABOR COSTS AND LOW LABOR PRODUCTIVITY ESPECIALLY DUE TO RIGIDITIES IN THE LABOR FORCE. THE RESULT HAS BEEN THAT SUCH INVESTMENT AS HAS OCCURRED HAS TENDED TO BE FOR CAPITAL-INTENSIVE MODERN EQUIPMENT, DESPITE RELATIVELY HIGH UNEMPLOYMENT AND UNDEREMPLOYMENT LEVELS.

12. THE EMPLOYMENT PROBLEM IN ITALY, PARTICULARLY OF FIRST-TIME JOB SEEKERS, IS PERHAPS MORE SERIOUS THAN IN ANY OTHER MAJOR INDUSTRIAL ECONOMY. IN ADDITION, IT REPRESENTS A DANGEROUS POLITICAL TINDERBOX. SPECIFICALLY, THERE IS GROWING POLITICAL PRESSURE FROM UNIVERSITY STUDENTS AND PRESSURES IN FAVOR OF THE SOUTH TO DO SOMETHING
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PAGE 02 ROME 10655 03 OF 03 281742Z

ABOUT UNEMPLOYMENT, ESPECIALLY OF YOUTH. IN LARGE PART, THE UNEMPLOYMENT PROBLEM IS DUE BOTH TO EXCESSIVE INCREASES IN UNIT LABOR COSTS AND TO DISINCENTIVES FOR HIRING DUE TO RIGID JOB SECURITY ARRANGEMENTS WHICH DISCOURAGE LABOR-INTENSIVE INDUSTRIES, AS WELL AS THE EFFECT OF AN EDUCATIONAL SYSTEM WHICH IS NOW UNRESTRAINEDLY OPEN AND FAVORS CREATION OF THE WRONG TYPE OF LABOR MARKET SKELL. THE GENERAL PUBLIC HAS ONLY RECENTLY BECOME AWARE OF THE EFFECT OF UNEMPLOYMENT OF THE GENEROUS WAGE AND FRINGE BENEFIT SYSTEM CREATED IN RECENT YEARS.

13. BY THE TIME OF ANDREOTTI'S VISIT, IT IS LIKELY THAT A SO-CALLED "PROGRAM ACCORD" WILL HAVE BEEN REACHED AMONG THE DC AND THE ABSTENTION PARTIES THE PRECISE ECONOMIC CONTENT OF THE PROGRAM IS NOT YET CLEAR. IT WILL LIKELY INCLUDE COMMITMENTS TO EXPAND INVESTMENT IN THE NEZZOGIORNO (SOUTH), IN HOUSING AND IN OTHER PRIORITY AREAS. HOWEVER, INCLUSION OF STRONG FOLLOW-UP ACTION ON THE BUDGET DEFICIT AND ON LABOR COSTS, WHICH IS NECESSARY TO PERMIT ACHIEVEMENT OF MEDIUM-TERM EXPORT, INVESTMENT AND EMPLOYMENT GOALS, IS UNCERTAIN. ASSUMING THAT THE "PROGRAM ACCORD" IS REACHED BEFORE THE ANDREOTTI VISIT, WE WILL SEND APPROPRIATE ANALYSIS.
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